Lease Vs. Bank

Which Type of Financing Makes the Most Sense For Your Business?

The first consideration for most executives is evaluating the objective of the transaction. Number one, is it *owning* equipment or *using* the equipment that will be the source of future profits to the business?

"Invest in Assets That Appreciate In Value… Lease (rent) Assets That Depreciate in Value"

It is generally accepted that "owning" business assets is particularly beneficial when those assets *appreciate* in value—real estate used to be a prime example. Most assets like computers and other office equipment only depreciate in value, in most cases fairly rapidly. When the objective is getting the maximum use out of a (rapidly) depreciating asset, it is that "use" that brings profits to the business, not the "appreciation" of the asset itself. Maximize the use...minimize the investment.

Leasing Make Business Sense and Tax Sense

Most businesses will ***write off 100% of their lease expenses***. Bank loans for equipment must be capitalized and depreciated under I.R.S. schedules over a period of 5, 6, 7 or more years. (The interest component can be deducted in the year incurred). Operating leases allow you deduct the entire payment and can effectively accelerate those write-offs, putting your cash, into your pocket sooner.

A Complete Solution

A typical lease covers as much as 110% of the equipment cost because it *also* covers the delivery, installation and other soft costs--in addition to the equipment itself. Our leases only require one (or two) month's rent in advance; there is a UCC filing only against the specific equipment leased; and the leasing company won't bother you for the next 3-5 years as long as you make your payments. At the end of that time, just return the equipment (with no further obligation!) and upgrade to new equipment, or the leasing company will sell you the equipment for its then-current fair market value (probably minimal); *and you will have **fully expensed the payments for tax purposes*** (unlike a term loan or credit line).

Is That "Prime Rate +…" Offer a Good Deal?

As you probably know, there is not a single prime rate; rather each bank is free to establish their own "prime" rate—sometimes it is as low as the Wall Street Journal prime, although we've often seen individual bank's prime (their best rates *to their most credit-worthy customers*), set as much as 4% above the benchmark WSJ-published rates. Let's assume for the sake of this example that your business qualifies and that your bank has offered you this month's (Dec 2010) WSJ prime rate of 3.65% plus a modest 1.25%. Sounds pretty good doesn't it? Maybe, but let's take a closer look.

Let's Talk Rates…

Obtaining a bank loan at such a "low" rate usually requires that you keep 20-30% of the loan amount in non-interest bearing, "compensating balance" accounts *at that bank*. Using the lower 20% figure for example, the bank is really lending you 80% of their money *and 20% of your own money*.

Is It 5.15%, or 15.16%?

(For this example let's assume; $100,000 net, for 60 months)

When you compute the real interest on the bank's 5.15%% loan offer, you find it is actually closer to 15.16%. (Here's why: Because you're paying interest on 100% of the "loan" amount, but have only received 80% of the money *from the bank,* the rest is your own ("compensating balance") being "loaned" back to you!. Your bank's "compensating balance" may be more or less—but anyway you slice it, the actual rate is a far cry from their original "prime +" offer.

Some business owners might say, "No big deal, we keep $10-20,000 in our business checking account *anyway…*" Perhaps so, but that's *your* business decision, for *your* convenience, today. What else could that same money—invested by you, or used for business opportunities or other capital acquisitions, be doing for you? With a compensating balance clause in the bank's loan/line offer, it becomes *a requirement*. Fall below that figure for any reason *and you are in default on your loan*. Change financial institutions or move to a more efficient interest bearing "sweep" account format for example and again you may be *in default*. It's all in the fine print.

What Else Is In The "Fine Print?"

Plenty. The following is a list of issues that have come up for many of our clients examining the same lease vs. bank decision. Here are some "bullet points" to compare and contrast typical commercial bank terms with First Capital's lease terms. There are many critical differences that you should examine closely.

"Bank Fine Print 101:"

- Bank line rates (and most loan rates) ***float*** with interest rates
  - ◊ **Lease rates are *fixed*** for the tem of the lease
  - ◊ Short-term rates may be low now, but they are on their way up—where will they "float" up to during the next 12, 24 or 60 months?
  - ◊ Are you comfortable pinning your business' budget to a constantly moving expense target?

- Do you have an existing line of credit at the bank?
  - ◊ What effect will a new loan have on the cash available under your business line, for special business opportunities, emergencies etc.? (In most cases your total access to funds will be *reduced by the amount of any new loan*)

- Is the bank actually offering a credit *line* or a *term* loan? There are some BIG differences:
  - ◊ Most banks require that credit lines be paid down to zero at least once every 12 months. Most also will reserve the option to call the line or loan should your industry start to "go south," or if the regional economy, or your own business prospects start to "soften" (In *their* sole opinion).
  - ◊ Where would you be if the bank elected *not to* renew in 12 months?

- Banks typically do not fund more than 75-80% of the net value of the equipment.
  - ◊ Our lease can cover as much as 110% of the full cost and unlike most banks; we *will* include shipping, training, installation, initial maintenance and other "soft" costs. So you don't get "nickeled and dimed" after at/after delivery for the additional things you need.

- Banks are far more restrictive than leasing companies, about the equipment they will finance.
  - ◊ Many banks will only do "hard" collateral (machinery, etc.) First Capital will lease all kinds of business or commercial equipment, even 100% software transactions.
  - ◊ Most banks will not even consider "used" equipment. First Capital does it all the time!

- The bank will place **a "blanket lien" on *all* of your assets**. (This is very important to consider)
  - ◊ First Capital's UCC will be filed *on the leased equipment ONLY*. Nothing else is encumbered. None of your financial flexibility will be compromised.
  - ◊ Keep in mind that if the bank were to decline to renew your line (at any point in the term) that those "blanket liens" *would still be in effect,* blocking your attempt to use your own assets as collateral for any new (replacement) funding.

- Most banks require ongoing financial disclosure. Make no mistake about it, with a bank line **you have a new "partner."** Almost every bank will *require* you to submit annual or quarterly financial statements and/or tax returns *for their review*. Further, bank loans are often conditioned on your maintaining certain bank-specified financial ratios. Working capital tests, debt-to-equity, current and quick ratios are commonly used and specified.
  - ◊ Will this hinder your ability to run your business, *as you deem prudent?*
  - ◊ It is routine for banks *to restrict your access* to any new debt obligations *from any other sources* without their express consent—and you cannot assume that you will receive it.
  - ◊ If you fall below the bank's mandated ratios, *you* will be in default.
  - ◊ There are absolutely no financial reporting requirements with a First Capital lease.

- The bank will likely require you to cross-collateralize *any new obligation* with all of the accounts you maintain at that institution—personal checking, savings, trusts etc. (this is often buried in the fine print as well)
  - ◊ Your lease with First Capital is a freestanding obligation.

- Even if you are not signing "personally" for *this* obligation with your bank, you may find that any previously signed, personal guarantee is deemed "continuing and unconditional" vis-à-vis all new obligations at that same institution. More fine print "hocus pocus!"

- Bank's fees and closing costs can run 1-4% of the transaction amount. These fees can have a significant effect on the real interest rate you are paying. Ask for a copy in writing before you sign…and do the math.
  - ◊ First Capital's *only* fee on a transaction under $50,000 is typically $150. ($350 for larger amounts)

- Are you a "key customer?" That may sound flattering, but it usually means that the bank is extending its offer based on your "entire banking relationship…" your other accounts, the other balances that you maintain *and* the service fees/income that your accounts generate for them.
  - ◊ It also means that you are tied to that bank exclusively for the term of the loan. If you move accounts and/or services, your rates will almost certainly jump up--way up. Not sure? Ask the bank specifically about this.

- Are bank-mandated "compensating balances" your best use of your own cash and operating capital? Where else could those funds be working (earning) for you, if they were not "committed" to maintaining the bank line?

- Merger Mania—Banks are "merging" and restructuring *all the time*. Your bank may be purchased by another bank. The surviving bank might have different lending criteria or may not "favor" your industry, or the equipment. Because default provisions are so loosely worded (intentionally); they probably have the ability to call your loan. They get their money back; you may be out in the cold.

Are You Ready To Pay These Very High Prices… For Those "Very Low Rates?"

Most customers find that they are being asked to pay a very high price for those seemingly "very low rates." Operating & financial restrictions, capital "frozen" as unproductive "compensating balances," business assets encumbered, future rate float risk, reduced availability of their own critical business credit lines etc., etc. Loans and lines that can be called….Leasing has become a trillion dollar industry right alongside the commercial banking industry *for good reason*. The points we have raised are just some of the many reasons why businesses from giant multi-nationals to local "mom & pops," have decided to "just say no" to their banker's overtures, selecting leasing instead!